New York Trip Report

March 27 - 31, 2017

Executive Summary

The popular Trump reflation trade (long USD and short rates) has reversed this year, as the Trump administration failed to deliver on its growth agenda

The resilience of equities is remarkable and brings back the memories of the late '90s – this year, five tech stacks have added USD 600 bn of market cap and accounted for more than 50% of Nasdaq 100' performance

Equity PMs are cautiously optimistic and not increasing their risk exposures until there is more clarity on the policy front

Credit PMs are still capitalizing on the aftermath of the HY energy crisis and are also increasingly diversifying into less liquid special situations

The ultra-low yield environment has made volatility selling very popular and also vulnerable if markets suddenly fall through support levels

The compression of volatility has caused many options arbitrage and quant equity strategies to underperform this year

Valuations have become very stretched and the current Shiller P/E is trading at levels not seen since the dotcom bubble while at the same time the Fed is hiking rates and considering to unwind its balance sheet

From the Trading Pit

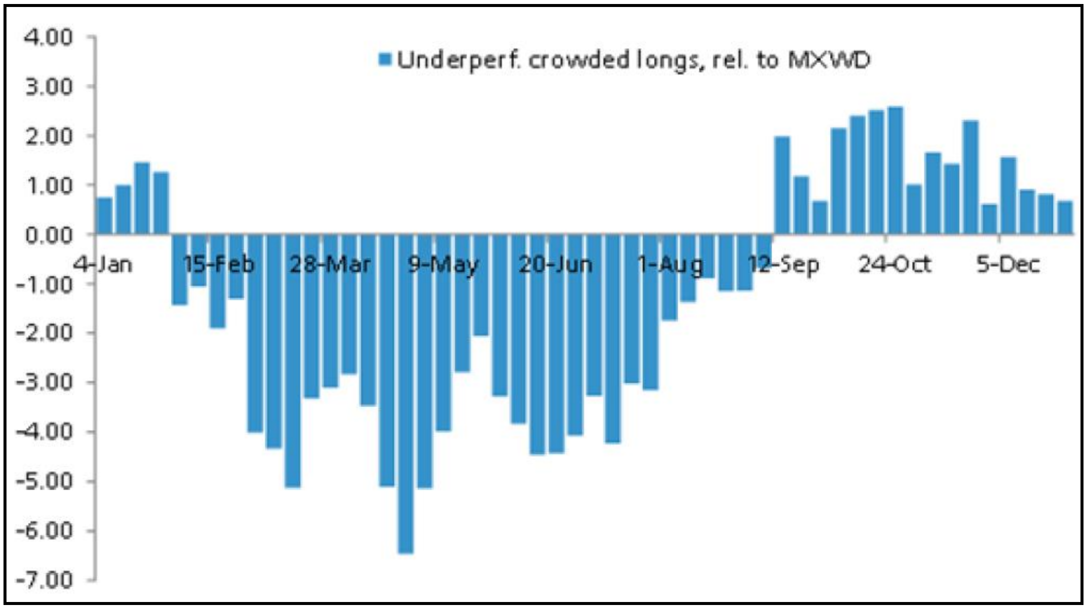
This has been our first New York trip since Trump got elected in November of last year. The so called "Trump Rally" that had started on the night of the election was characterized by a stronger US dollar, rising interest rates and outperforming cyclical and small cap stocks. It pushed the domestic equity indices well into positive territory for the year. The Dow Jones Industrial Average Total Return Index finished the year up 16.5% while the S&P 500 TR Index gained 12.0%.

After Trump's election, most macro managers were convinced that 2017 would be marked by higher volatility and persistent trends in asset classes given Trump's stance on global trade agreements, his strong growth agenda of lower taxes, more fiscal stimulus and regulatory reforms. What we have seen so far is almost the opposite. Volatility has been on a declining path and the reversal in the USD and in interest rates have hurt many macro funds such as Karya and Atreaus who were positioned for a stronger USD and rising rates. Atreaus' Todd Edgar has lost on all of his nine trades he did in the first quarter, a bad streak that is unprecedented in his 24-year investment career. Despite Trump not delivering on most of his campaign promises so far, US equity markets have shrugged off the concerns regarding Trump's legislative agenda and continued to rally on the back of healthy economic numbers and strong earnings growth. According to FactSet, first quarter earnings for the companies in the S&P 500 rose nearly 14%, the biggest jump since the third quarter of 2011. The rally of the tech stocks unsurprisingly benefitted our growth manager Alkeon, which continues to be very optimistic about the outlook for technology, driven by recent advances in the fields of artificial intelligence, display technologies, 3D sensing, etc.

While equities have advanced, volatilities across various asset classes have continued to decline. The compression of volatility acts as a headwind for funds which rely on volatility such as Laurion and AlphaQuest. Quant funds that rely on mean-reversion (Clinton Equity Strategies, Academy and R&F Capital) also suffered from the lack of volatility. On the other hand, short volatility strategies have benefitted from the current environment. Aroya, a seller of expensive VIX options, has profited from declining volatility. Yet, the VIX has reached such low VIX levels, that the PM has reduced its exposure given heightened risks of a VIX spike. In commodities, the range-bound oil markets led to losses at Massar Capital, a dedicated commodity fund which was long crude oil in the first quarter. Despite the setback in oil prices, he still expects crude to rebound in the second half of the year based on his fundamental analysis (target price for WTI 55 to 60 USD per barrel). Ramius Merger Arbitrage has reached its high-watermark again and is profiting from the healthy deal flow environment this year. High profile launch MANA Partners, a quant driven shop which combines traditional hedge fund statistical arbitrage strategies with high frequency trading, has some very ambitious performance goals, but hasn't been able to deliver much performance yet. They are still expecting to roll out additional stat arb strategies to finance the expensive high frequency trading operation.

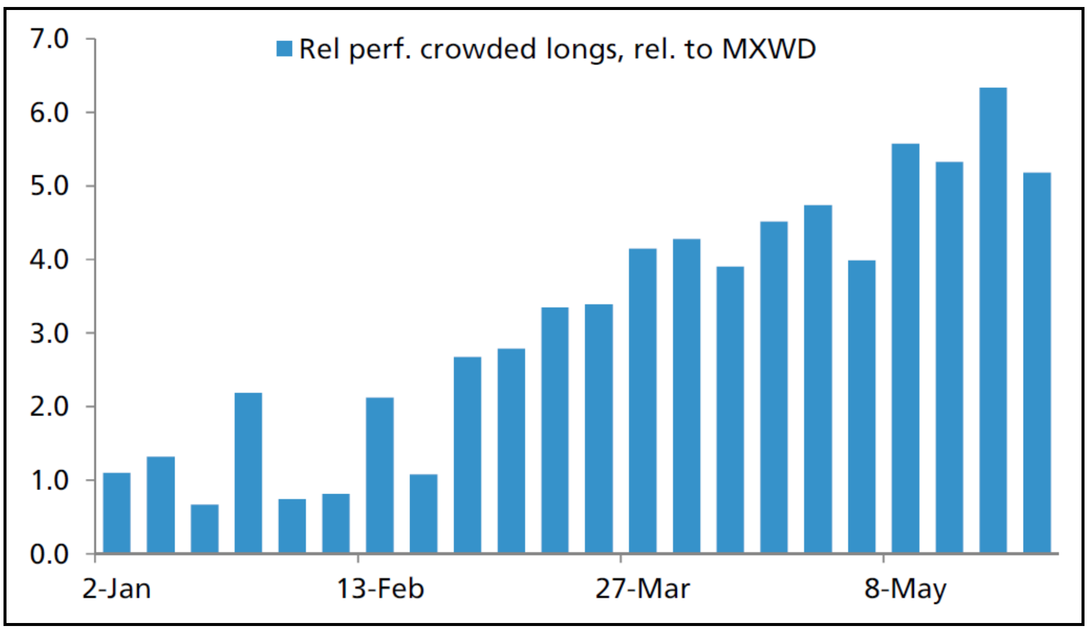
Overall, the managers that we met during the trip were cautiously optimistic. The majority of equity long/short PMs are not increasing their exposures (Aurmedis and Jafra) until they see more clarity on the policy front. Jafra's Randy Yuen, who has started his own fund last year after years at Soros and Duquesne, has adopted a more tactical approach for the time being. Long tech stocks seems to be a common theme, specifically FANG (Facebook, Amazon, Netflix and Google). The only standout in this category was TMT focused EastBay which is short Facebook and Amazon, expecting those stocks to disappoint given heightened expectations. Popular hedge fund holdings have underperformed for a good part of last year, whereas this year crowded longs are outperforming according to UBS prime brokerage data:

Cumulative performance of crowded hedge fund longs in 2016:



Source: UBS

Cumulative performance of crowded hedge fund longs YTD:

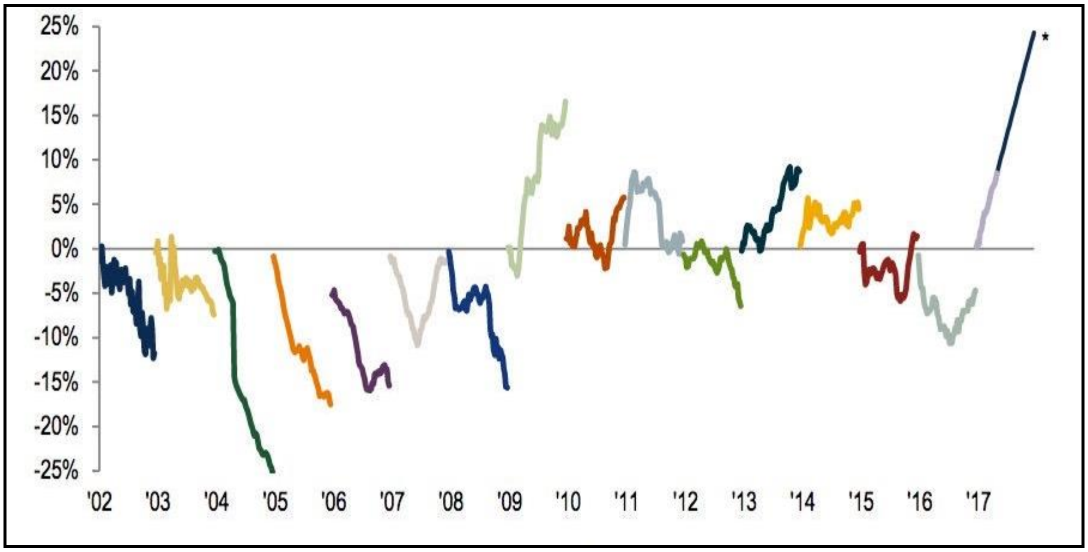


Source: UBS

FANG, FAAMG and Volatility

While FANG has dominated investor focus, the acronym has lately evolved into FAAMG (Facebook, Amazon, Apple, Microsoft and Google). Those five stocks alone have added a total of USD 600 bn of market capitalization this year and are responsible for approximately 55% of the Nasdaq 100 performance YTD and for ca. 40% of the YTD gains in the S&P 500 according to Goldman Sachs calculations. Bank of America Merrill Lynch estimates that the broad tech sector is currently experiencing inflows not seen since 15 years:

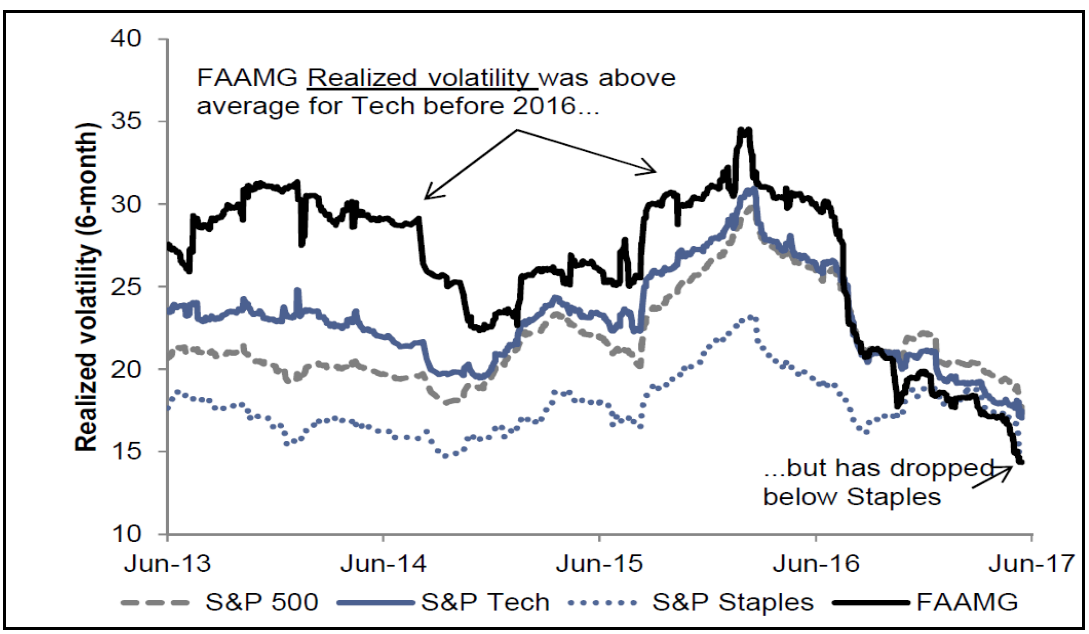
Tech flows as % of AuM



Source: BoAML

Parallels to the "Nifty-Fifty" and the "dotcom" bubble are growing as their performance is even more pronounced on a risk-adjusted basis. Realized volatility (6 months) for FAAMG has fallen over the last year and is trading not only below that of the average stock in the S&P 500 but also below the average of consumer staples and utility stocks. Realized volatility has declined to the point that they now look more like consumer staples than tech stocks.

FAAMG realized volatility

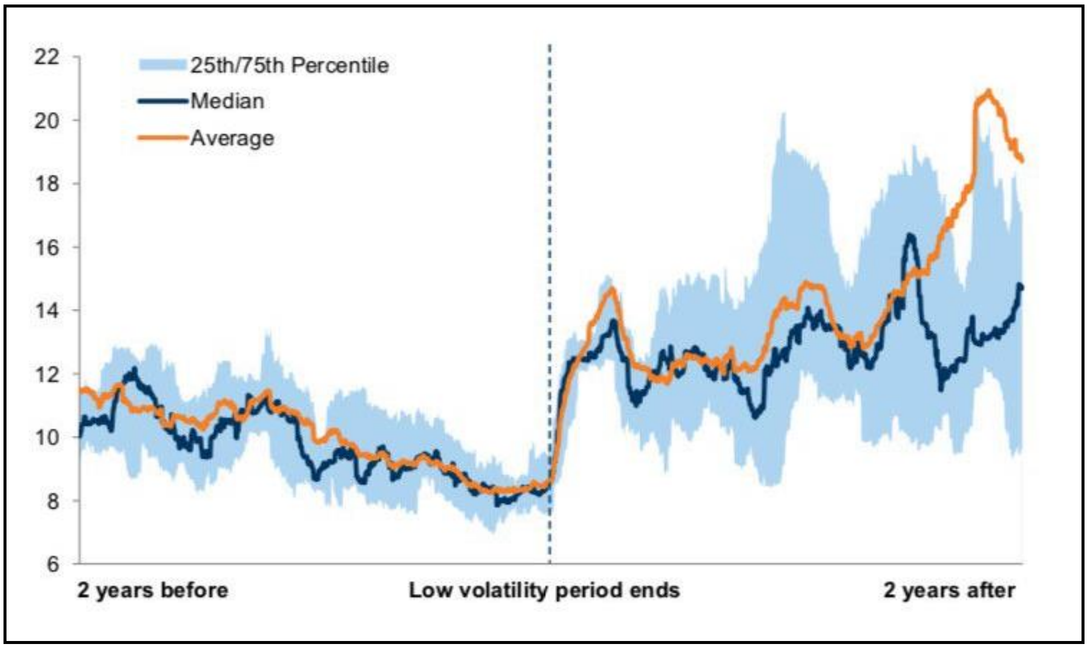


Source: Goldman Sachs

Since the US Presidential Election the FAAMG stocks have traded like defensive stocks, exhibiting a positive correlation to staples and utilities. The correlation is near the highest level in the last five years, an anomaly which is unsustainable in the long run.

Realized volatility is not only low in the tech sector but across all S&P 500 sectors as well. The main drivers of low volatility are the currently low levels of correlation, the supply of options through risk premia products and inflows into passive low vol strategies. Looking back at history, it looks very likely (and logical) that the current low vol environment is going to be followed by a higher vol environment. Interestingly, the transition from a low vol to a higher vol regime doesn't appear to be so "smooth":

S&P 500 3-month volatility during and after a low vol period since 1928:



Source: Goldman Sachs

The current high level of complacency is unlikely to be sustainable as multiple sources of risks are lurking. The current business cycle has seen an expansion phase that is now more than eight years running, far away from the roughly six year average length since World War II. This aging business cycle coincides with global financial assets at record valuation levels and a Shiller P/E of 29.5, a level surpassed only during the dotcom bubble. Add to that the Fed, which has started raising rates and will begin unwinding its balance sheet, we could finally be shifting to a more "normal", higher volatility regime which should be beneficial for many hedge fund strategies that are predicated on volatility.